

**The Economic Substance Doctrine and GAAR:
A Critical and Comparative Perspective
[DRAFT]**

Jinyan Li*

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* Associate Professor, Osgoode Hall Law School of York University, Policy Research Institute, Monash University, Melbourne. The Author thanks Rick Krever, Daniel Sandler and Scott Wilkie for their comments on the earlier draft of this paper.

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1. INTRODUCTION

“Subsection 245(4) recognizes that the provisions of the Act are intended to apply to transactions with real economic substance, not to transactions intended to exploit, misuse or frustrate the Act to avoid tax.”

- *Explanatory Notes* (1988)¹

“While the “economic substance” of the transaction may be relevant at various stages of the [s.245] analysis, this expression has little meaning in isolation from the proper interpretation of specific provisions of the Act. Any “economic substance” must be considered in relation to the proper interpretation of the specific provisions that are relied upon for the tax benefit.”

- *Canada Trustco* (2005)²

In *Canada Trustco Mortgage Company v. Canada* (2005)³ and *Mathew v. Canada* (2005) (sub-nom, “*Kaulius*”),⁴ the Supreme Court of Canada (SCC) ruled for the first time on the application of the general anti-avoidance rule (GAAR) in section 245 of the Income Tax Act (the “Act”). In a unanimous decision, the Court upheld the decision of the lower courts, which means that GAAR applied in *Kaulius*, but not in *Canada Trustco*. This result was not surprising to most observers. The Court clarified the general principle of statutory interpretation and some specific guidelines for applying the GAAR.⁵

¹ Canada, Department of Finance. *Explanatory Notes to Legislation Relating to Income Tax*. Ottawa: Queen’s Printer, 1988, at 464-5. The Supreme Court of Canada quoted the above paragraph in *Canada Trustco* (paras. 48-49).

² *Canada Trustco Mortgage Company v. Canada*, 2005 SCC 54.

³ 2005 SCC 54.

⁴ 2005 SCC 55.

⁵ For a general comment on these decisions, see David Duff, “The Supreme Court of Canada and the General Anti-Avoidance Rule: *Canada Trustco* and *Mathew*”, a paper written for the GAAR Symposium on November 18, 2005. For the implications of these decisions on the burden of proof in GAAR cases, see Daniel Sanlder, “The Minter’s Burden under GAAR”, also a paper for the GAAR Symposium.

The economic substance doctrine was apparently “saved” from its deathbed and made relevant to the application of GAAR, but only where the provisions of the Act were intended to apply to transactions with real economic substance. There are good reasons to think that the *Canada Trustco* and *Kauliaus* cases “have done little to clarify when GAAR will apply”⁶, or worse still, that they continued the trends that rendered GAAR largely ineffective.⁷ The Court clearly failed to provide clear guidelines on the “different interpretations” of the doctrine. The Court’s analysis of this doctrine was disappointing.

Given that the SCC was not prepared to hear another GAAR case anytime soon,⁸ Parliament may wish to amend s.245(4) by specifically requiring the courts to consider the “real” economic substance of a transaction by looking at whether there is any potential for profit (other than the tax savings) or any meaningful change in the economic position of the taxpayer.⁹ In the absence of legislative guidance, lower courts wishing to incorporate economic substance will do so simply by stating that it is derived from a textual, contextual, purposive analysis of the provisions in issue while less innovative courts can ignore the doctrine altogether. The application of the GAAR will be uncertain.

This paper argues that section 245 of the Act calls for the application of the “real” economic substance doctrine. “Excluding any consideration of economic substance and economic realities under subsection 245(4) ... would render the GAAR incapable of ever applying”¹⁰ This paper also argues that the economic substance doctrine can be applied objectively with a reasonable degree of certainty and predictability and serve as a useful tool in separating “legitimate tax planning” from “abusive tax avoidance”.

This paper has the following parts: following the introduction in Part 1, Part 2 discusses what “economic substance” doctrine is all about and overviews the history of this doctrine in the United States and the United Kingdom. Part 3 discusses the economic

⁶ Sandler, *id.*

⁷ Brian Arnold (2004), “The Long, Slow, Steady Demise of the General anti-Avoidance Rule” (2004) 52 *Can. Tax J.* 488 at 510.

⁸ Sandler, *supra.*

⁹ This was suggested by Arnold (2004), *supra.*

¹⁰ *Id.*, at 510.

substance doctrine as applied in *Canada Trustco* and *Kaulius* and the implications of these decisions. Part 4 provides an international perspective on the economic substance doctrine, namely the treatment of the doctrine as a matter of statutory interpretation in the UK, as a judicial anti-avoidance rule in the US, and as part of the statutory GAAR (e.g., Australia, and South Africa). Part 5 is the core of the paper and argues for the introduction of the economic substance doctrine in Canadian GAAR analysis. Part 6 concludes the paper with a call for better understanding of the real economic substance doctrine and a more robust application of this doctrine in determining abusive tax avoidance.

2. THE ECONOMIC SUBSTANCE DOCTRINE

2.1 The Doctrine and Its Various Interpretations

Under the economic substance doctrine, transactions or arrangements are characterized in accordance with their economic substance or realities. Since income tax is based on statute, this doctrine is relevant to the application of statutory provisions to the facts of a case. As such, it is an important part of statutory interpretation. Because this doctrine is invoked mostly in tax avoidance cases, it can also be regarded as an anti-avoidance doctrine.

As the SCC mentioned in *Canada Trustco*, the expression “economic substance” may have different interpretations. Although the Court did not elaborate on these various interpretations, a review of the historical development of this doctrine suggests that there are perhaps three different interpretations:

- “Real” economic substance. This is the American notion under which the economic substance is determined by looking at both objective and subjective factors to see if there is any potential for profit other than tax savings or if there is any meaningful change in the economic position of the taxpayer.

Under this doctrine, transactions lacking economic substance are ignored for tax purposes.

- Step transaction plus business purpose. It is perhaps the UK version. It combines the step transactions doctrine and business purpose doctrine and enables the courts to overlook the step transactions that serve no business purpose.
- “Substance over form” or “legal substance”. This narrow interpretation was adopted in pre-GAAR jurisprudence in Canada. It is used to characterize a transaction/arrangement according to the legal effects.

Which interpretation of the economic substance doctrine is applied in a case largely depends on the approach taken in interpreting the statutory provisions and the judicial attitude towards tax avoidance.

2.2 *Gregory v. Helvering* (1934) and the Real “Economic Substance” Doctrine

The leading American case of *Gregory v. Helvering* (1934)¹¹ is often cited as the source for “first principles” on the economic substance doctrine.¹² In this case, Mrs. Gregory owned all the stock of United Mortgage Corporation (United), which held among its assets 1,000 shares of stock of the Monitor Securities Corporation (Monitor). Mrs. Gregory desired to liquidate the shares of the Monitor stock, but was not thrilled about the two levels of taxation to which the proceeds from the sale would be subjected if she simply directed United to sell the Monitor stock, and then distribute the proceeds to herself. Consequently, Mrs. Gregory organized a new company, transferred the Monitor stock to this new company three days after, dissolved the new company within the same

¹¹ 69 F. 2nd 809 (1934).

¹² E.g., J. Isenbergh, “Musings on Form and Substance in Taxation” (1982) 49 *U. Chi. L. Rev.* 859, at 866; David Hariton, “Sorting Out the Tangle of Economic Substance,” (1999) 52 *Tax Law* 235; S. Patton, “Treasury Regulation s.301.6111-2T and the Economic Substance Doctrine: A Plea for Certainty in the Tax Law,” (2002) 39 *Hous. L. Rev.* 499, at 509.

week, caused it to transfer the Monitor shares to her as part of the dissolution, and recognized the gain as a capital gain. Ostensibly, these transaction met the requirements of a “reorganization” under the Revenue Act of 1928. As such, the transfer of Monitor stock to the new company would be tax-free, and the subsequent liquidation of the new company would give rise to capital gains in the hands of the shareholder who had received the distribution of shares. The result of the transaction, however, was the same as a simple dividend distribution, and the Commissioner sought to tax it as such. Should the transaction be characterized according the form or the economic result?

Learned Hand, J. writing for a panel of judges of great intellectual prestige,¹³ held that the transaction conformed to the literal language of the statute, and if it fell within the language of the statute, it did not matter that it was done solely to avoid tax. However, he opined that the concept of “reorganization” involves doing something for a business purpose and not solely to avoid tax. He stated:

It does not follow that Congress meant to cover such a transaction The meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create.

If what was done here was what was intended by [the statute], it is of no consequence that it was all an elaborate scheme to get rid of income tax, as it certainly was. . . . [But] the purpose of the section is plain enough; men engaged in enterprises . . . might wish to consolidate, or divide, to add to, or subtract from, their holdings. Such transactions were not to be considered as realizing any profit, because the collective interests still remained in solution. But the underlying presupposition is plain that *the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as*

¹³ Isenbergh, id., at 867.

an ephemeral incident, egregious to its prosecution... To dodge the shareholders' taxes is not one of the transactions contemplated as corporate "reorganizations". ... We cannot treat as inoperative the transfer of shares... The transfer passed title ... and the taxpayer became a shareholder in the transferee. All these steps were real and their only defect was that they were not what the statute means by a 'reorganisation'.¹⁴

Learned Hand's reasoning "has left echoes in every corner of the tax law"¹⁵ in the United States and beyond. The italicized words quoted above mark the birth of the economic substance doctrine.¹⁶ Mrs. Gregory was denied the benefit of her objective tax result because her transaction did not change her economic position, apart from the tax benefit, nor did it reflect any facet of the business of United. In other words, Mrs. Gregory's transactions lacked economic substance, and it was not "the thing which the statute intended."¹⁷ As discussed further below in Part 4, the economic substance doctrine (which now encompass a business purpose test) has subsequently become one of the most effective common-law anti-avoidance rules in the United States.

2.3 Duke of Westminster v. I.R.C. (1935) and "Form Over Substance" Doctrine

In the famous case *Duke of Westminster* (1935),¹⁸ which is contemporary to *Gregory v. Helvering* (1934), the House of Lords established a set of principles which, until recently, have been profoundly influential in the United Kingdom and remain influential in Canada today. These principles are:

- The Act is to receive a strict or literal interpretation;
- A transaction is to be judged not by its economic or commercial substance but by

¹⁴ Id., 810-811.

¹⁵ Isenbergh, *supra*, at 867.

¹⁶ Id.

¹⁷ Learned Hand's decision was upheld by the Supreme Court: *Gregory v. Helvering*, 293 U.S. 465. The Supreme Court stated the question as "whether what was done ... was the thing which the statute intended." Id., at 469.

¹⁸ *Inland Revenue Commissioners v. Duke of Westminster* [1936] A.C. 1 (H.L.).

- its legal form; and
- A transaction is effective for tax purposes even if it has no business purpose, having been entered into solely to avoid tax.

The facts in *Duke of Westminster* were straightforward. The Duke of Westminster had a number of household servants. The then *British Income Tax Act* did not allow a deduction of wages of household servants, but allowed a deduction of annual payments made in pursuance of a legal obligation other than remuneration of servants. The Duke accordingly entered into deeds of covenant with each of his servants under which he undertook to pay each of them annual sums for a period of seven years. The payments were to be made irrespective of whether any services were performed by the promisee, and were without prejudice to the promisee's entitlement to remuneration if he or she did perform any services to the promisor. However, it was established by evidence that the understanding between the Duke and his servants was that they would rest content with the provision made for them by deed, and would not assert any right to remuneration. In this way, the Duke converted his non-deductible wages obligation into a deductible annuity obligation.

There was no doubt that the deeds were legally effective in that all legal formalities had been carried out. Nor were the deeds shams: the Duke had covenanted to pay the annuities for seven years, and had thereby assumed the risk of having to continue to pay an annuitant who had stopped working for him or who had insisted upon additional remuneration for working for him. Of course, the understanding that the faithful retainers would continue to work for him, and would do so without extra charge, virtually eliminated this risk. But the risk was genuinely assumed, and none of their lordships regarded the deeds as shams. Lord Atkin, the sole dissenter, was the only law lord who found the device unsuccessful in avoiding tax. For Lord Atkin, "the substance of the transaction was that what was being paid was remuneration".¹⁹ But for the other law lords

¹⁹ *Id.*, at 15.

the legal forms were controlling and the Duke was entitled to deduct the payments.

2.4 *Ramsay v. I.R.C. (1982)* and *Furniss v. Dawson (1984)*: Step Transactions plus Business Purpose

The *Duke of Westminster* principles are not compatible with the American notion of economic substance doctrine (or its close cousins, the form over substance doctrine, step transactions, or business purpose test). As such, this doctrine was rejected under the traditional strict interpretation approach and became relevant only when the purposive interpretation method became accepted. During the 1980s, the House of Lords began to endorse the purposive interpretation approach and gradually recognized the relevance of the economic substance doctrine as a question of statutory interpretation. However, the UK notion of economic substance doctrine is not as broad as the American notion and is firmly anchored as a matter of statutory interpretation, not a freestanding anti-avoidance rule.

In *Ramsay Ltd. v. I.R.C. (1982)*²⁰ Lord Wilberforce stated that the courts are not confined to literal interpretation and should have regard to the context, scheme of the Act and the purpose of the Act. With respect to the form over substance doctrine in the *Duke of Westminster* case, he stated that this principle “must not be overstated or over-extended.

While obliging the court to accept documents or transactions, found to be genuine, as such, it does not compel the court to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs. If it can be seen that a document or transaction was intended to have effect as part of anexus or series of transactions, or as an ingredient of a wider transaction intended as a whole, there is nothing in the doctrine to prevent it being so regarded; to do so is not to prefer form to substance,

²⁰ [1982] AC 300, at 326. In this case, counsel for the government referred the House of Lords to some of the American cases on the business purpose rule, including *Gregory v. Helvering*.

or substance to form. It is the task of the court to ascertain the legal nature of any transaction to which it is sought to attach a tax or a tax consequence and if that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded.

As such, Lord Wilberforce did not fully adopt the “business purpose” test in *Gregory v. Helvering*, but found the business purpose test relevant in rejecting steps that have no business purpose. He identified three key features of avoidance schemes: the self-canceling structure of the schemes, non-commerciality, and the expectation that all the consecutive steps in the exercise would be performed even though there was no contract stipulating that they would be.

In *Furniss v. Dawson* (1984)²¹ the House of Lords charged the vendor of property with a capital gain, although the capital gain had actually been received by a company owned and controlled by the vendor that was incorporated in the Isle of Man (a tax haven). Their lordships held that the transaction was to be regarded as a sale and purchase between two United Kingdom parties, which was the commercial reality. The intermediate step of transferring the property to the controlled Isle of Man company (which then sold the property to the true purchaser) had been undertaken solely to divert the capital gain to the Isle of Man and avoid its recognition in the United Kingdom.²² Their lordships held that this “inserted step”, because it had “no business purpose apart from the deferment of tax”, was to be disregarded for tax purposes. The business purpose test of *Furniss v. Dawson* has been confined to “step transactions”, or “composite transactions”, as they are known in the United Kingdom.²³ As discussed in Part 4 below, however, the UK courts have recently moved away from the *Ramsay* and *Furniss v. Dawson* principles in *Barclays*

²¹ *Furniss v. Dawson*, [1984] A.C. 474 (HL).

²² The gain would eventually have to be recognized in the United Kingdom, but only when the shares in the Isle of Man company (whose value reflected the capital gain) were sold.

²³ *Furniss v. Dawson* followed two earlier decisions of the House of Lords, namely, *Inland Revenue Commrs. v. Burmah Oil Co.*, [1982] S.T.C. 30 (H.L.) and *Ramsay, supra*. The later case of *Craven v. White*, [1989] A.C. 398 (H.L.) confined *Furniss* to step transactions.

Mercantile Business Finance Ltd. v. Mawson (2005).²⁴

2.5 Canadian Pre-GAAR Jurisprudence and “Substance over Form”/“Legal Substance”

In pre-GAAR jurisprudence in Canada, the “real economic substance” doctrine was not part of Canadian law.²⁵ When “substance over form” was referred to, “substance” referred to “legal substance” as opposed to “economic” substance. For example, in *Continental Bank of Canada v. R.* (1995)²⁶ Bowman J.T.C.C. held that the requirement to consider “substance over form” in income tax law does not mean that the legal effect of a transaction is irrelevant, nor does it mean that one is entitled to treat substance as synonymous with economic effect. He held that he could not ignore the form of the legally binding relations in this case because the essential nature of a transaction cannot be altered for income tax purposes by nomenclature. Bowman J.T.C.C. concluded that the ultimate purpose of the transactions did not warrant a disregard of the legal relations created by the scheme; therefore, the parties had formed a valid partnership. His decision was upheld by the SCC.²⁷

This “legal substance” notion of economic substance is not much different from “form over substance” doctrine established in the *Duke of Westminster* case:²⁸ the deeds of covenant that the Duke entered into with his servants were effective for tax purposes despite the fact that they had been brought into existence solely in order to avoid tax. The courts had no power to disregard a transaction for tax purposes simply because the transaction lacked an economic substance or independent business purpose.

²⁴ [2005] AC 685 (HL).

²⁵ Brian Arnold, “Reflections on the Relationship Between Statutory Interpretation and Tax Avoidance” in Harry Erlichman, ed. *Tax Avoidance in Canada: The General Anti-Avoidance Rule* (2002), 41-81, at 67.

²⁶ [1995] 1 C.T.C. 2135, 94 D.T.C. 1858 (TCC).

²⁷ *Continental Bank of Canada v. R.*, 98 D.T.C. 6505, [1998] 4 C.T.C. 119, [1998] 2 S.C.R. 298 (SCC), para.12.

²⁸ *Inland Revenue Commissioners v. Duke of Westminster* (1935), [1936] A.C. 1 (H.L.).

2.6 Relationship between Economic Substance Doctrine and Statutory Interpretation

As a matter of statutory interpretation, the economic substance doctrine can be relevant simply as a characterization issue. The importance of characterization cannot be over-emphasized because different types of transactions give rise to different tax treatment and the Act leaves most of the characterization issues to the courts (e.g., “employment”, “business” “property” “cost”, etc.). The source of difficulty is that the Act necessarily has a limited number of terms, but must be applied to a nearly unlimited range of transactions. Many of the basic terms of the Act are therefore imported into it with their meaning established in private law. In characterizing a taxpayer's transaction for tax purposes, the challenge is whether the legal rights and obligations created by the taxpayer should be respected for tax purposes. In other words, should the judges rely on the characterization on the basis of the legal form of the transaction or the substance of the transaction? The answer to this question is crucial in tax avoidance cases. In the *Duke of Westminster* case,²⁹ the success of the Duke's tax avoidance plan depended upon the Court's willingness to characterize the agreements entered into with his servants as annuity contracts rather than employment contracts. The Court's acceptance of the legal form (annuity) rather than the commercial substance (employment) was critical to the success of the plan. Similarly, in the *Stuart Investments Ltd. v. R.* (1984)³⁰ case, the Court accepted the legal forms (sale and agency agreement), although the commercial substance of the arrangement was that Stuart had not divested itself of the business.³¹

The question whether a transaction should be characterized for tax purposes according to its legal form or according to its commercial substance is obviously a different question from whether the Act should be given a strict or a purposive interpretation. But the two questions are intimately related. The courts cannot disregard genuine legal forms unless the Act expressly or implicitly directs that result. Under a regime of strict interpretation, the courts are less likely to read the Act as authorizing an inquiry that goes beyond the

²⁹ *Id.*

³⁰ [1984] C.T.C. 294, 84 D.T.C 6305 (S.C.C.).

³¹ *Stuart*, *infra*.

legal forms than they are under a regime of purposive interpretation. Under a regime of purposive interpretation, the argument that the Act imposes liability on an economic result, as opposed to a legal form, becomes more appealing.

Broadly speaking, the economic substance doctrine, like other common law doctrines, can be thought of as a matter of statutory interpretation.³² But it is not an interpretative method, like the traditional strict interpretation method or the modern purposive interpretation method. The economic substance doctrine has a more natural fit with the latter method. In this sense, it is difficult to reconcile the adoption of a “textual, contextual and purposive” interpretation of statutory provisions with the adoption of a narrow/formalistic construction of the facts. Justice Dickson observed this connection in *Bronfman Trust v. R.* (1987):³³

I acknowledge, however, that just as there has been a recent trend away from strict construction of taxation statutes ... , so too has the recent trend in tax cases been towards attempting to ascertain the true commercial and practical nature of the taxpayer's transactions. There has been, in this country and elsewhere, a movement away from tests based on the form of transactions and towards tests based on what Lord Pearce has referred to as a "common sense appreciation of all the guiding features" of the events in question...³⁴

Unfortunately, the SCC was clear about adopting the purposive statutory interpretation principle in *Canada Trustco* and *Kaulius*, but not so clear about the construction of facts based on the broad notion of economic substance.

³² In the United States, because the doctrine functions as a judicial anti-avoidance law, in some respects it resembles a substantive canon of interpretation. J. Bankman, “The Economic Substance Doctrine,” (2000) 74 Cal. L. Rev. 5, at 11.

³³ *Bronfman Trust v. R.*, [1987] 1 S.C.R. 32, [1987] 1 C.T.C. 117, 87 D.T.C. 5059 (S.C.C.).

³⁴ *Id.*, para.48.

3. CANADA TRUSTCO AND KAULIUS

3.1 Interpreting Section s.245(4)

In *Canada Trustco* and *Kaulius*, it was not difficult for the court to conclude that the first two requirements for the application of GAAR were met. That is, there is a tax benefit arising from a transaction or series of transactions within the meaning of s.245(1) and (2). Second, the transaction is an avoidance transaction in the sense of not being “arranged primarily for bona fide purposes other than to obtain the tax benefit.” The key issue before the SCC is whether the third requirement is also met, that is whether the transaction was an abusive avoidance transaction under s.245(4) in the sense that it cannot be reasonably concluded the transaction did not result in a misuse of the provisions of the Act or an abuse having regard to the provisions of the Act read as a whole. These cases indicate the crucial role of s.245(4) as the threshold for a transaction to constitute an “avoidance transaction” has been set very low.

In interpreting s.245(4), the Court consolidated the “misuse” and “abuse” tests into a single “abuse” test and set forth two-part inquiry in determining whether an abuse has occurred. The first part is to interpret the provisions giving rise to the tax benefit in order to determine their object, spirit and purpose (collectively referred to as “legislative purpose”). This statutory interpretation issue is a question of law. The statutory interpretation principle is purposive – the Court must “look beyond the mere text of the provisions and undertake a contextual and purposive approach to interpretation in order to find meaning that harmonizes the wording, object, spirit and purpose of the provisions of the Income Tax Act” (para.47). In other words, it is no longer sufficient to rely on the literal meaning of the specific provisions.

Once the meaning and purpose of the statutory provisions are determined, the second part is to determine whether the avoidance transaction falls within or frustrates the legislative

purpose of the statutory provisions. The SCC regarded this as a question of fact and it is for the Tax Court judge to determine whether the Minister has established abusive tax avoidance under s.245(4) (para.44). The SCC also stated that the decision of the Tax Court should not be overturned by an appellate court unless there has been a palpable and overriding error. This point is controversial because it is not clear why the most crucial element of GAAR analysis is a question of fact. As discussed below, the courts in other countries do not view this as a pure factual question.

The two-part analysis will lead to a finding of abusive tax avoidance when the “taxpayer relies on specific provisions of the *Income Tax Act* in order to achieve an outcome that those provisions seek to prevent” or “when a transaction defeats the underlying rationale of the provisions that are relied upon. An abuse may also result from an arrangement that circumvents the application of certain provisions, such as specific anti-avoidance rules, in a manner that frustrates or defeats the object, spirit or purpose of those provisions” (para.45). The SCC made it clear that “abuse is not established where it is reasonable to conclude that an avoidance transaction under s. 245(3) was within the object, spirit or purpose of the provisions that confer the tax benefit.” (id.)

The test for determining abuse is objective in that abuse is not established where it is reasonable to conclude that an avoidance transaction was within the object, spirit or purpose of the provisions that confer the tax benefit. The court must consider all of the relevant facts, including whether the transaction was motivated by any non-tax purpose. However, “s.245(4) does not consider a transaction to result in abusive tax avoidance merely because an economic or commercial purpose is not evident.” (para.57). Parliament intended for many of such transactions to “endure” the GAAR attack.

With respect to the economic substance doctrine, the SCC quoted the statement in the Explanatory Notes – “the provisions of the *Income Tax Act* are intended to apply to transactions with real economic substance” (para.56). It confirmed that the “economic

substance” of the transaction “may be relevant at various stages of the analysis” (para.76), and the determination of abuse must be made in relation to the specific provisions of the Act (para.76). The Court stated:

Abusive tax avoidance may be found where the relationships and transactions as expressed in the relevant documentation lack a proper basis relative to the object, spirit or purpose of the provisions that are purported to confer the tax benefit, or where they are wholly dissimilar to the relationships or transactions that are contemplated by the provisions.
(para.76)

If the above passage is read together with the Court’s acknowledgement that “the provisions of the Act are intended to apply to transactions with real economic substance” (para.56), one may argue that the Court “endorsed” the economic substance doctrine in GAAR analysis. Since the provisions of the Act are intended to apply to transactions with real economic consequences, transactions lacking such real economic consequences are presumably inconsistent with legislative intention, and thus constitute abusive tax avoidance. The only exception is where the provisions of the Act are specifically intended otherwise. Unfortunately, however, that is probably not what the SCC was saying.

3.2 *Canada Trustco*

The facts of *Canada Trustco* involve a factually complex but conceptually straight forward type of leveraged lease:

- Canada Trustco borrowed approximately \$97 million from Royal Bank of Canada (RBC). RBC’s recourse against Canada Trustco was limited.
- Canada Trustco used the borrowed funds and \$23 million of its own money to purchase certain trailers from an American company (TLI) for their agreed

fair market value of \$120 million. Trailers were chosen to generate high capital cost allowance (CCA) deductions and are not subject to the specified leasing property rules.

- Canada Trustco immediately leased the trailers to a UK company (MAIL, which is controlled by RBC), which was TLI's subsidiary, with an option to purchase.
- MAIL in turn immediately sub-leased the trailers back to TLI under terms parallel to those under the lease between Canada Trustco and MAIL. In other words, on paper, the trailers left TLI when they were "sold" to Canada Trustco, but immediately returned to TLI via MAIL when they were leased back to TLI.
- TLI immediately prepaid all of its sub-lease obligations to MAIL for \$116 million. As a result, TLI had no ongoing sublease payment obligations under the sublease.
- The next day, MAIL deposited in a RBC account \$97 million of the sublease payment received from TLI. This amount was equal to the amount of loan from RBC to Canada Trustco. In effect, RBC's loan to Canada Trustco was secured. MAIL transferred the \$19 million balance of the sublease payment to an offshore affiliate of RBC (RBC Jersey) on the condition that RBC Jersey would use the funds to purchase a government of Ontario bond.
- RBC Jersey purchased the government of Ontario bond, which it in turn pledged to Canada Trustco in support of certain MAIL obligations (i.e., its option to purchase) on termination of the lease from Canada Trustco to MAIL. The financial risk of Canada Trust's own investment (\$23 million) was minimized.
- Canada Trustco immediately assigned to RBC the rent payments from MAIL under the lease. Canada Trustco also provided MAIL with an instruction to pay the assigned rent payments to RBC, so that RBC would apply the rent payments directly to the instalment payments due by Canada Trustco to the

bank under the terms of the loan. RBC's recourse under the loan was limited to the rent payments assigned to it by Canada Trustco. The rent payments under the lease would be applied to pay off the loan, and the remainder of the purchase price would be covered by the government of Ontario bond.

In essence, the \$120 million investment by Canada Trustco (net of the \$4 million diverted to TLI for its participation) returned with minimal risk. The parties entered into a variety of pledge and security agreements to achieve the overall effect that each party involved was fully secured in respect of its financial risk and entitlement.

For Canadian tax purposes, Canada Trustco treated the stated cost of the trailers as their capital cost and deducted CCA in computing its profit. It was also entitled to deduct the interest expense on the loan from the bank. These deductions exceeded the lease income, thereby generating a loss. The loss was used to shelter Canada Trustco's other income from tax. The evidence of internal correspondence within Canada Trustco clearly indicated that the key to the transaction was the advantageous CCA treatment that Canada Trustco would receive. The Minister invoked GAAR in denying the CCA deductions.

This transaction had the hallmarks of a tax shelter. It was set up by an arranger. It involves minimal financial risk to the parties. Canada Trustco's own investment (\$23 million) was insignificant in comparison with the stated value of the trailers (\$120 million) and the CCA deductions (\$36.2 million in 1996 and \$46.3 million in 1997). In any event, Canada Trustco's own money was secure through trust and pledge arrangements with RBC and RBC Jersey. The transaction involves a largely disinterested third party (TLI) whose involvement in the transaction was very brief.

The Tax Court of Canada had no difficulty finding that there was a tax avoidance transaction. Justice Miller acknowledged the fact that in sale-leaseback transactions, the

generous CCA treatment is intrinsic to the commercial venture, and that this case involves a situation where tax considerations are inextricably caught up in the commercial venture.³⁵ Nonetheless, he found that the primary purpose was to obtain the tax benefit from the investment – the tax benefit drove the deal.³⁶ He then shifted the GAAR analysis to the “misuse or abuse” test.

In his misuse analysis, Justice Miller stated that the policy regarding the CCA system “is to provide for the recognition of money spent to acquire qualifying assets to the extent that they are consumed in the income earning process.”³⁷ He also found that policy underlying the leasing property rules is to limit the CCA deductions against leasing income. The transaction in *Canada Trustco* was similar to most sale-leaseback transactions involving exempt properties (Reg.1100(1.13(a)), and was not abusive. The taxpayer’s cost was the purchase price of the asset, as evidenced by the contracts entered into by the taxpayer. Citing the statement in *Shell Canada v. R.*(1999)³⁸ that “absent a specific provision ... to the contrary ... legal relationships must be respected”,³⁹ Justice Miller found no specific “provision requiring cost be determined on any economic reality test for purposes of the application of the CCA regime in the context of sale-leaseback-like arrangements..... It is the legal cost which is determinative, not the real economic cost.”⁴⁰

Justice Miller’s decision was affirmed by the Federal Court of Appeal. The Minister of National Revenue sought leave to appeal to the SCC, and leave to appeal was granted. At the SCC, the Crown argued that: (1) the object and spirit of the CCA provisions are “to provide for the recognition of money spent to acquire qualifying assets to the extent that they are consumed in the income-earning process” (*Water’s Edge Village*, para.44); (2) the circular sales-leaseback transaction involved “no real risk” and that Canada

³⁵ *Canada Trustco v. R.* [2003] 4 C.T.C. 2009, 2003 D.T.C. 587, (T.C.C.), para.53.

³⁶ *Id.*, para.57.

³⁷ *Water’s Edge Village Estates (Phase II) Ltd. v. Canada*, [2003] 2 F.C. 25, 2002 FCA 291, para. 44.

³⁸ [1999] 4 C.T.C. 313, 99 D.T.C. 5669 (Eng.) (S.C.C.).

³⁹ *Canada Trustco* (T.C.C.), para. 71.

⁴⁰ *Id.*, para. 73.

Trustco did not actually spend \$120 million to purchase the trailers. Therefore, Canada Trustco created a “cost for CCA purposes that is an illusion” without incurring any “real” expenses, which contravenes the object and purpose of the CCA provisions and constitutes abusive tax avoidance. The Crown’s following submission is along the line of an economic substance argument:

In this case, the pre-ordained series of transactions misuses and abuses the CCA regime because it manufactures a cost for CCA purposes that does not represent the real economic cost to CTMC of the trailers. ... There was no risk at all that the rent payments would not be made. Even the \$5.9 million that CTMC apparently paid in fees was fully covered as it, along with the rest of CTMC’s contribution of \$24.9 million in funding, will be reimbursed when the \$19 million bond pledged to CTMC matures in December 2005 at \$33.5 million.

The taxpayer relied on the Tax Court’s conclusion that the “transaction was a profitable commercial investment and fully consistent with the object and spirit of the Act”. (para.71) It argued that the policy of the Act is that “cost” means the amount price that the taxpayer gave up in order to get the asset, except in specific circumstances not applicable to the case at issue, and that a cost is not reduced to reflect a mitigation of economic risk. Thus, the transaction was not abusive. The respondent’s position prevailed.

The SCC found that the purpose of the CCA provisions, as applied to sale-leaseback transactions, was to permit deduction of CCA based on the cost of the assets acquired. “This purpose emerges clearly from the scheme of the CCA provisions within the Act as a whole” (para.74). The provisions of the Act do not refer to “economic risk” and refer only to “cost.” The specific leasing property rules implicitly reflect decisions about the economic implications of certain sale-leaseback transactions. In the context of CCA, cost is a well-understood legal concept. The Court stated: “Like the Tax Court Judge, we see nothing in the GAAR or the object of the CCA provisions that permits us to rewrite them

to interpret “cost” to mean “amount economically at risk” in the applicable provisions” (para.76).

The Court rejected the Crown’s argument. According to the Court, the Crown’s submission on “economic substance” of the transaction was “narrow” “because it did not focus on the purpose of the CCA provisions read in the context of the Act as a whole in determining whether the tax benefit fell outside the object, spirit or purpose of the CCA provisions” (para.76).

3.3 *Kaulius*

Kaulius involved the transfer of business losses from a corporation to unrelated persons through the use of a partnership. Standard Trust Company was in the business of lending money on the security of mortgages of real property. As a result of financial difficulties, Standard Trust was wound up in 1991. A portion of Standard Trust’s assets comprised of mortgage loans (referred to as “STIL II portfolio”) which had a total cost of \$85 million and a fair market value of \$33 million, thus a \$52 million accrued loss. These losses were of no value to Standard Trust because of its insolvency. In order to maximize the amount realized by Standard Trust on liquidation, the liquidator devised a plan to sell the portfolio. The following steps were taken:

- Standard Trust incorporated a wholly-owned subsidiary.
- Standard Trust entered into a partnership with the subsidiary (Partnership A). The interests of Standard Trust and its subsidiary in Partnership A were 99 percent and 1 percent, respectively.
- The STIL II portfolio was transferred to Partnership A at the cost of \$85 million by virtue of subsection 18(13) of the Act.⁴¹

⁴¹ By reason of s. 18(13) of the Act, the \$52 million loss from the transfer of the portfolio to the partnership was disallowed, but added to the cost of the portfolio to the partnership. As a result, the cost of the portfolio

- The liquidator carried out an intensive campaign to market the Standard Trust's 99 percent interest in Partnership A and eventually sold it to OSFC, after difficult and protracted negotiations.
- OSFC assigned its partnership interest to a general partnership (Partnership B).
- The respondents in this case were remaining partners of Partnership B (other than OSFC) who purchased their interests in Partnership B from OSFC. They claimed their proportionate shares of the losses from the eventual sale or write-down of the STIL II portfolio and offset the losses against their own incomes.

The result of these transactions is that the \$52 million losses were transferred to various taxpayers arm's length to Standard Trust through s.18(13) and the partnership vehicle.

In a separate case, *OSFC Holdings Ltd. v. R.* (2001)⁴² the Federal Court of Appeal ruled against the taxpayer and held that the transactions constituted abuse of the provisions of the Act read as a whole. OSFC's application for leave to appeal to the Supreme Court was denied. In *Kaulius*, not surprisingly, the taxpayers lost at both the Tax Court and the Federal Court of Appeal. When they applied for leave to appeal, surprisingly, the Supreme Court granted the application. At the SCC, the parties conceded that the transactions gave rise to a tax benefit and that the transactions did constitute avoidance transactions. The question was whether the transactions resulted in abusive tax avoidance.

Applying the two-part tests under s.245(4), the SCC first posed the question, "Would allowing the appellants to deduct the losses frustrate the object, spirit or purpose of subsection 18(13) and the partnership provisions of the Act?" (para. 35) Following the textual, contextual and purposive interpretation of s.18(13) and s.96, the Court held that the purpose of statutory provisions is "to prevent a taxpayer who is in the business of lending money from claiming a loss upon the superficial disposition of a mortgage or

to the partnership was \$85 million.

⁴² [2001] 4 C.T.C. 82, 2001 D.T.C. 5471 (Fed.C.A.), discussed under heading 20.4(d), "Transaction" or "series of transactions", below.

similar non-capital property,” (para.53) and not to facilitate the transfer of losses to arm’s length persons.

Did the transaction frustrate such legislative intent or purpose? The court answered “yes”. In reaching this conclusion, the following facts seemed relevant:

- (a) the losses were originated from the failure of Standard Trust;
- (b) Partnership A served as a “holding vehicle” for the unrealized losses that Standard Trust planned from the outset to sell to arm’s length parties;
- (c) Partnership B was relatively passive and its purpose was simply to realize and allocate the tax losses without any other significant activity;
- (d) Even though the partners of Partnership B paid substantial amounts in order to acquire their partnership interests and sought to minimize their exposure to risk, these facts cannot negate the conclusions under (b) and (c);
- (e) neither Partnership A or Partnership B ever dealt with real property, apart from the original mortgage portfolio from Standard Trust;
- (f) Standard Trust was never in a partnership relationship with either OSFC or any of the appellants; and
- (g) the “vacuity and artificiality” of the non-arm’s length aspect of the initial relationship between Partnership A and Standard Trust.

The real economic substance of the transactions is that the partners of Partnership B paid about \$1.5 million to acquire interests in the partnership in order to gain access to the tax loss. They in fact deducted over \$10 million of the losses.⁴³ In the absence of the tax savings, there is virtually no return on their investment. However, the investment is “profitable” when the value of tax loss deduction is taken into account.

⁴³ For the appellants in this case, they deducted over \$10 million of the losses against their own incomes. Some of appellants, in addition to reducing their taxable income for the relevant year to NIL, but also generated a non-capital loss to be carried over to other years.

3.4 The Lay of the Land on economic substance in Canada

Prior to the SCC decision in *Canada Trustco*, the “economic substance” doctrine “did not have any sound jurisprudential foundation” in Canada.⁴⁴ It is true that the SCC mentioned the possible relevance of this doctrine in *Bronfman Trust*:

Assessment of taxpayers’ transactions with an eye to commercial and economic realities, rather than juristic classification of form, may help to avoid the inequity of tax liability being dependent upon a taxpayer’s sophistication at manipulating a sequence of events to achieve a patina of compliance with the apparent prerequisites for a tax deduction.”⁴⁵

It is also true that McLachlin J. also remarked in *Shell Canada v. R.*(1999)⁴⁶ that “courts must be sensitive to the economic realities of a particular transaction, rather than being bound to what first appears to be its legal form.”⁴⁷ But McLachlin J’s following caveat effectively “eviscerated”⁴⁸ the economic substance doctrine:

... [T]his Court has never held that the economic realities of a situation can be used to recharacterize a taxpayer’s bona fide relationships. To the contrary, we have held that, absent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer’s legal relationships must be respected in tax cases.⁴⁹

⁴⁴ Arnold (2002), *supra*.

⁴⁵ It should be noted that in *Bronfman*, it was the taxpayer that argued the economic reality doctrine. The taxpayer trust had borrowed funds and used them to make a distribution to a beneficiary. It argued that the borrowed funds were used for the purpose of earning income indirectly because it could have sold some of its assets, distributed the proceeds from the sale, and then borrowed to replace its assets.

⁴⁶ [1999] 4 C.T.C. 313, 99 D.T.C. 5669 (Eng.) (S.C.C.).

⁴⁷ Para.xx.

⁴⁸ Arnod, *supra*.

⁴⁹ *Shell Canada, supra*, para.39.

Has the SCC changed its position on “economic substance” in *Canada Trustco* and *Kaulius*? The answer is “yes” and “no”. Evidence on the “yes” side includes the following:

- The Court clarified that the application of s.245(4) involves an objective test – the “only reasonable conclusion” is that the avoidance transaction frustrated the object, spirit or purposes of the specific provisions relied upon by the taxpayer in deriving the tax benefit.
- The SCC stated that the economic substance of the transaction “may be relevant at various stages of the [GAAR] analysis” (*Canada Trustco*, para.76)
- The notion of economic substance perhaps influenced the Court’s decision in *Kaulius* because the transaction was in substance a loss-transmission, which was not “intended” by the “stop-loss” rule in s.18(13). The Court also considered a number of factors that are relevant in determining “real” economic substance.

On “No” side, evidence includes:

- The Court may not be saying anything different in *Canada Trustco* than in *Shell*. In *Shell*, absent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer’s legal relationships must be respected in tax cases. In *Canada Trustco*, economic substance should be taken into account when a textual, contextual purposive analysis of the specific provisions of the Act requires it to be taken into account (i.e., in a specific provision of the Act to the contrary).
- The Court did not elaborate on the different interpretation of “economic substance”. The results of the *Canada Trustco* case seem to indicate that the Court was taking the narrow, “legal substance” notion of the economic substance doctrine. The transaction was characterized by the taxpayer and the Tax Court as similar to an ordinary sale lease-back transaction, the SCC accepted it without going through the economic factors of profit potential or

significant change in Canada Trustco's financial position (in the absence of the tax savings). In this sense, what the SCC did in *Canada Trustco* is not much different from *Shell*.

- The Court said that the Crown's view that Canada Trustco's cost is nil is narrow because it failed to focus on the legislative purpose of the CCA provisions. Certainly, the Crown's view was "narrow", but for a different reason. It was narrow because it did not consider other economic factors relevant to the determination of economic substance (see Part 5 below). What the SCC was trying to say may be the following: the economic substance of the taxpayer's transaction in the *Canada Trustco* was not relevant because the CCA provisions of the Act did not call for it. If so, the Crown's consideration of economic substance is not just narrow, but not relevant.

The current state of law with respect to the economic substance doctrine is unsettled in Canada. When the *Canada Trustco* decision is compared with the *Barclays Mercantile*, the statutory GAAR in Canada did not seem to make any difference in the court's analysis of the issue.

4. ECONOMIC SUBSTANCE DOCTRINE IN UK, US, AUSTRALIA AND SOUTH AFRICA

4.1 UK: A Matter of Statutory Interpretation

During the years following the *Ramsay* decision, the courts in the United Kingdom appeared to be ready to import the "full-blooded American doctrine" developed in *Gregory v. Helvering*.⁵⁰ For example, in *IRC v. Burmah Oil Co Ltd* (1982)⁵¹ the House of Lords refused to accept that the taxpayer had achieved the magic result of creating a tax loss that was not a real loss. Lord Scarman said that in considering any tax avoidance scheme "it is now crucial . . . to take the analysis far enough to determine whether a

⁵⁰ L. Hoffman, "Tax Avoidance", 2005 *British Tax Rev.* 2, at 200.

⁵¹ STC 30 at 39.

profit, gain or loss is really to be found”.⁵² Lord Diplock said that in deciding whether a composite circular transaction had caused Burmah to suffer a loss for capital gains tax, one could ignore “inserted steps that have no commercial purpose”. This was interpreted as an explicit application of the American economic substance or business purpose test.⁵³ The case did not depend upon the analysis of the meaning of the word “loss” or the nature of the concept which that word involves.

Similarly, in *C.I.R. v. Challenge Corporation Ltd.* (1986),⁵⁴ the Privy Council held that the taxpayer simply “pretended that they suffered a loss when in truth the loss was sustained by [other taxpayers].” Lord Templeman stated:

In an arrangement of tax avoidance the financial position of the taxpayer is unaffected (save for the costs of devising and implementing the arrangement) and by the arrangement the taxpayer seeks to obtain a tax advantage without suffering that reduction in income, loss or expenditure which other taxpayers suffer and which Parliament intended to be suffered by any taxpayer qualifying for a reduction in his liability for tax.

At the turn of the century, however, the courts shifted the focus back towards textual statutory interpretation. In *MacNiven v. Westmoreland Investments Ltd.* (2003)⁵⁵ the question was whether a company could deduct interest for the purposes of corporation tax. In order to deduct, it had to have paid the interest. It had no money, so the lender, which happened to be its parent company, made it a loan which it paid back in discharge of the interest liability. This was a circular transaction, undertaken purely to save tax because the lender happened to be exempt from tax on the interest which it received and the payment generated a tax loss in the insolvent borrower which gave it some value in the market. The House of Lords considered the statute and concluded that the statute required no more than that the interest liability should have been discharged by a

⁵² Id.

⁵³ Hoffman, *supra*.

⁵⁴ [1987] 1 AC 155.

⁵⁵ [2003] 1 AC 311 (H.L.).

payment which was taxable in the hands of the lender, or would have been taxable if it had not been exempt. The purpose of the payment was irrelevant. The basis of *MacNiven* was that:⁵⁶

[E]ven if the payment in question was undertaken solely for the purpose of obtaining tax relief, the granting of such relief in such circumstances was nevertheless within the intendment of the statute.

In other words, the statute was interpreted to tolerate formality. If the statute was intended to require merely legal substance, then what the taxpayer did in this case satisfied that requirement.

The *MacNiven* approach has been reaffirmed by the recent decisions of the House of Lords in *Barclays Mercantile Business Finance Ltd. v. Mawson* (2005)⁵⁷ and *I.R.C. v. Scottish Provident Institution* (2004).⁵⁸ *Barclays Mercantile* shows that there is no general overriding judicial anti-avoidance approach to statutory interpretation. *Scottish Provident* shows that the House of Lords are not prepared to use this approach to endorse contrived, artificial, avoidance transactions.

The facts in *Barclays Mercantile* were similar to that in *Canada Trustco*. An Irish government-owned company, (BGE), had built a pipeline. It sold the pipeline to the taxpayers (BMBF) for £91.3 million. BMBF immediately leased the pipeline back to BGE which granted a sub-lease onwards to its UK subsidiary. BGE immediately deposited the sale proceeds with the Barclays and had no access to the funds for 31 years. None of the parties had anything to lose from the transaction, designed to produce substantial U.K. tax deductions, and no other economic consequences of any significance. The Inland Revenue denied BMBF's deductions for depreciation because the series of transactions amounted to a single composite transaction that did not fall within s.24(1) of the Capital Cost Allowance Act 1990. In a unanimous decision, the House of Lords held in favor of the taxpayer. The House of Lords stated:

⁵⁶ Per Lord Millett in *Collector of Stamp Revenue v. Arrowtown Assets Ltd.*, [2003] HK CFA 46 at 143.

⁵⁷ [2005] AC 685 (HL).

⁵⁸ [2004] UKHL 52 (HL).

The driving principle in the Ramsay line of cases continues to involve a general rule of statutory interpretation and unblinkered approach to the analysis of the facts. The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically.⁵⁹

In looking at the statutory provisions, the House of Lords found that the object of granting the allowance was to provide a tax equivalent to the normal accounting deduction from profits for the depreciation of machinery and plant used for the purposes of a trade. The statutory requirements were concerned entirely with the acts and purposes of the lessor. The Act said nothing about what the lessee should do with the purchase price, how he should find the money to pay the rent or how he should use the plant. The statutory test was based on the purpose of the lessor's expenditure, not the benefit of the finance to the lessee. Moreover, the House of Lords found that from the BMBF's point of view the purchase and lease back were part of its ordinary trade of finance leasing. "Indeed, if one examines the acts and purposes of BMBF, it would be very difficult to come to any other conclusion."⁶⁰

Lord Hoffman suggests in an article that the decision in *Barclays Mercantile* has "killed off" the *Ramsay* doctrine as a special theory of revenue law and subsumed it within the general theory of the interpretation of statute.⁶¹ Upon a closer examination of the decision, it can be argued that the House of Lords did not interpret the statute purposively. One commentator remarked:

The purpose of the applicable statute was to stimulate investment in plant and machinery by reducing the cost of that investment through the tax benefit of depreciation deductions concerning the purchase price. In finance leasing, the lessor shares the tax benefit with the lessee as lower rents. If the

⁵⁹ *Barclays Mercantile*, supra, para.36, quoting Ribeiro PJ in *Collector of Stamp Revenue v. Arrowton Assets*, supra note 25.

⁶⁰ *Barclays Mercantile*, id., para. 41.

⁶¹ Hoffman, supra, at 203.

acquisition or construction of the capital equipment in question has already been paid off for and no refinancing is occurring, a sale and lease-back will not stimulate investment by reducing cost, and therefore is not within the scope of the depreciation provision, construed purposively.⁶²

In *Scottish Provident*, the same Committee of the House of Lords reached an opposite decision and ruled against the taxpayer. In this case, the taxpayer company was trying to take advantage of an apparent gap in the transitional rules when the loan relationship rules came into force. Citibank and Scottish Provident Institution (SPI) granted each other call options over government securities (gilts) on terms that would result in no economic change (other than the receipt of a fee by Citibank) after the options were exercised, but would reduce a deductible loss for SPI on its acquisition and sale of the securities. Under this arrangement, SPI bought a right to buy five-year gilts at 90 per cent of their par value in return for a premium; it sold a right to buy five year gilts at 70 per cent of their par value. The idea was that the premium would not be taxable because SPI was a mutual life company and the deal would be carried out before the new rules came into force in 1996 while the related (but netted out) loss would be allowed because it was timed so as to fall under the new rules. In order to minimize the risk of the contracts being disregarded for tax purposes as self-canceling transactions, the exercise price of the option granted to SPI was set sufficiently close to the current fair market value of the securities so that the exercise price might conceivably exceed the market price on the maturity date. If that were to happen, SPI would not exercise the option, but would acquire securities in the open market to meet its obligations to deliver them to Citibank.

The question in *Scottish Provident* was whether there was a “debt contract” for the purposes of s.150A(1) of the Finance Act 1994. A debt contract was a contract under which a qualifying company “has an entitlement ... to become a party to a loan relationship.” A loan relationship includes a government security. The House of Lords upheld the *Ramsay* principle and regarded the series of transactions as a composite

⁶² J. VanderWolk, “U.K. House of Lords’ Dual Tax Decisions Muddy Ramsay Principle,” (2005 37 *Tax Notes Int’l* 743, at 745.

transaction. Further, the composite transaction created no entitlement to the securities and that there was thus no qualifying contract. The artificial nature of the scheme was noted:⁶³

There was no commercial reason for choosing a strike price of 90. From the point of view of the money passing (or rather, not passing), the scheme could just as well have fixed it at 80 and achieved the same tax saving by reducing the Citibank strike price to 60. It would all have come out in the wash.

It may be difficult to reconcile the court's decision in *Barclays Mercantile* and *Scottish Provident* along the line of the *Ramsay* principle or economic substance-composite transaction doctrine. It could be said that the scheme in *Barclays Mercantile* was equally artificial where several transactions take place on the same day, the money goes round in a circle and uses a Jersey company owned by a charitable trust and an Isle of Man finance company.⁶⁴ On the other hand, however, these two cases could be reconciled on the ground that both adopted more or less the "legal substance" notion of the economic doctrine and firmly rejected the current American notion of economic substance.

4.2 US: Economic Substance Doctrine as a Judicial Anti-Avoidance Rule

The economic substance doctrine in the United States is the basis for this paper's definition of "real economic substance." This doctrine was "born from one woman's desire to lower her tax bill"⁶⁵ in *Gregory v. Helvering*. Under the economic substance doctrine, "courts have long held that if a business transaction has no value except to create tax losses, then it can be disallowed by the I.R.S. Otherwise, tax lawyers could just move symbols around pieces of paper, and their clients would never pay taxes."⁶⁶ The economic substance doctrine can also be described as a doctrine under which "transactions or arrangements [may] be disregarded if they lack a non-tax business

⁶³ *Scottish Provident Institution*, supra, para.22.

⁶⁴ Trevor Johnson, "UK Tax Update: Like a Circle in a Spiral, Like a Wheel within a Wheel", (2002) 27 *Tax Notes Int'l* 1297.

⁶⁵ Pratton, supra, at 509.

⁶⁶ D. C. Johnston, "A Tax Shelter, Destroyed," *New York Times*, July 13, 2003.

purpose”;⁶⁷ “a doctrine of statutory interpretation that says that the taxpayer is not entitled to the benefit of the statute that [the taxpayer] seeks to abuse, even if [the taxpayer] has a technical argument for the result.”⁶⁸

The economic substance doctrine is considered an effective and necessary anti-avoidance rule.⁶⁹ It incorporates the common-law anti-avoidance doctrines of sham transactions, substance over form, business purpose, economic profit, and step transactions.⁷⁰ It is necessary because “the use of black letter rules, unconstrained by some sort of economic substance or business purpose requirement, could lead to the elimination of wholesale swathes of corporate income tax liability.”⁷¹

A transaction lacks economic substance if it “can not with reason be said to have purpose, substance, or utility apart from [its] anticipated tax consequence.”⁷² The U.S. courts have developed a two-prong test for determining whether a transaction lacks economic substance:

- The objective prong looks at whether the taxpayer has shown that the transaction had economic substance beyond the creation of tax benefits;
- The subjective prong looks at whether the taxpayer has shown that it had a business purpose for engaging in the transaction other than tax avoidance.⁷³

The courts are divided on what each prong means and the relationship between the two prongs. Some courts insisted that the two prongs are interrelated (unitary test); although

⁶⁷ Martin J. McMahon, Jr., *Economic Substance, Purposive Activity, and Corporate Tax Shelters*, TAX NOTES TODAY, Feb. 22, 2002, TaxBase, TA Doc. No. 2002-4664, P5.

⁶⁸ G.W. Miller, Jr., “Corporate Tax Shelters and Economic Substance: An Analysis of the Problem and Its Common Law Solution,” (2003) 34 *Tex. Tech. L. Rev.* 1015, at1025.

⁶⁹ Hariton, “Sorting Out the Tangle of Economic Substance”, (1999) 52 *Tax Law* 235 at 241.

⁷⁰ Bankman, *supra*, at 12. In *Long Term Capital Holdings*, *infra*, the Court stated at p.137: “The terminology used, whether sham, profit motivation, or economic substance, is not critical, rather the analysis evaluates both the subjective business purpose of the taxpayer for engaging in the transaction and the transaction’s objective economic substance, and a finding of either a lack of a business purpose other than tax avoidance or an absence of economic substance beyond the creation of tax benefits can be but is not necessarily sufficient to conclude the transaction a sham.”

⁷¹ Miller, *supra*, quoting Daniel N. Shaviro & David A. Weisbach, *The Fifth Circuit Gets it Wrong in Compaq v. Commissioner*, TAX NOTES TODAY, Jan. 28, 2002.

⁷² *Goldstein v. Commissioner*, 364 F. 2d 734).

⁷³ *Frank Lyon Co. v. United States* (1978), 435 U.S. 561 was considered to be the leading case that created this test.

some courts have also stated that a transaction that has objective economic substance will be respected for tax purposes, regardless of the taxpayer's motivation.⁷⁴

4.2.1 *Objective economic substance*

Long Term Capital Holdings is one of the recent cases in which the economic substance doctrine was applied.⁷⁵ It is rather ironic that the arrangement designed by a great economic mind, Myron S. Scholes, winner of a Nobel in economics, was found to lack economic substance. The essence of the arrangement was to allow loss duplication through the contribution by Onslow Trading & Commercial LLC (OTC) of the preferred stock with a built-in loss to a partnership, the sale of the contributor's partnership interest to the general partner, and the subsequent sale of the loss stock by the partnership. The transactions involving Long Term Capital included the following:

- During 1996, OTC transferred the preferred stock to Long Term Capital Partners LP (LTCP), a hedge fund, in exchange for a partnership interest in LTCP. OTC borrowed the cash component of its contribution from Long Term Capital Management UK (a UK entity related to LTCP). OTC also purchased from LTCM a put option with respect to its interest in LTCP.
- LTCP in turn contributed the preferred stock to a lower-tier partnership called Portfolio. Both LTCP and Portfolio claimed that OTC's \$107 million basis in the stock carried over to them in tax-free transaction (per s.721 of the Internal Revenue Code).
- At the end of 1997, Portfolio sold the preferred stock to an investment bank (B&B) for approximately \$1 million, producing a loss of \$106 million.

⁷⁴ Bankman, *supra*, at 26.

⁷⁵ For a review of these cases, see Y. Keinan, "The Many Faces of the Economic Substance's Two-Prong Test: Time for Reconciliation?" (2005 1 *N.Y.U.J.L & Bus.* 371.

- Portfolio allocated the capital loss to LTCP, which then allocated the capital loss in received to LTCM.

The arranger of this deal received a partnership interest in LTCP and a consulting fee of \$1.2 million. Another consultant earned a fee of \$1.8 million. LTCM earned fees for assets under management, proportional to the return achieved for the investors. Long Term Capital relied on the additional fees it would earn from both the OTC and some investment to justify its ability to earn pre-tax return. This case is similar to *Kaulius* in that the loss was “transferred” to the partnership and the amount of tax savings vastly exceeded any non-tax return on the investment.

The U.S. District Court for the District of Connecticut held that OTC’s contribution of the preferred stock to LTCP, OTC’s sale of its partnership interest to LTCM, and Portfolio’s subsequent sale of the preferred stock to an investment bank lacked economic substance and must be disregarded for federal income tax purposes. The court held that in the alternative that the transactions must be recast under the step transaction doctrine as a taxable sale by OTC directly to LTCM. The court also upheld a 40% penalty for gross valuation misstatement.

With respect to the objective economic substance test, the taxpayer argued that the test ought to be whether there was a meaningful change in the taxpayer’s economic position. The court rejected this argument and held that the analysis is based on a approach from the standpoint of a prudent investor:⁷⁶

...[A]n approach that finds a transaction has economic substance and will be recognized for tax purposes if the transaction offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits. the test should be whether there was a “reasonable opportunity for economic profit, that is, profit exclusive of tax benefits.

⁷⁶ *Long Term Capital Holdings*, supra, at 139.

The court took a cost/benefit analysis and held that it was not reasonable for the taxpayer to expect a non-tax-based profit from the transactions considering the hefty transactional costs incurred. The court compared the potential profit to the sizeable amounts paid as attorney fees, consultant fees, partnership distributions, bonuses, and related-party loans. In establishing the potential profit, the court generously assumed the above-market returns (which the hedge fund was known for), but excluded certain management fees and included only the management fees LTCM could earn on the OTC investment, and ignored the economic value of partner relationships. Such cost/benefit analysis led the court to conclude that the transaction lacked economic substance simply because no prudent investor would knowingly and intentionally incur costs above a reasonable gain.

In other cases, the courts determined the objective economic substance by looking at whether the transaction alters the taxpayer's economic position in a meaningful way, whether there is enough potential for profit, and whether there are legitimate reasons for structuring the transaction. For example, in the Supreme Court decision in *Frank Lyon Co.* (1978)⁷⁷ a sale-leaseback transaction was found to have economic substance. In this case, the taxpayer borrowed \$ 7.1 million, bought a building from a bank for \$7.6 million (the loan plus \$ 500,000 of the taxpayer's own funds), and leased the building back to a bank for rent equal to the taxpayer's payments of principal and interest on the \$7.1 million loan. The term of the lease was 25 years, with options to extend it up to 40 more years. The lease agreement also provided the taxpayer with a fixed rate of return on its \$500,000 investment. At the end of the lease term, the bank could either acquire the building or extend the lease. The taxpayer claimed depreciation deductions from building and interest deductions on the loan, and reported the payments from the bank as income from rent. The US Supreme Court stated that "where . . . there is a . . . transaction . . . which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties." The Supreme Court upheld the transaction because

⁷⁷ L.R. Scott, "Sale-Leaseback v. Mere Financing: Lyon's Roar and the Aftermath," (1982) *U.Ill.L.Rev.* 1075.

there existed a tax-independent business purpose and the **economics** of the transaction were authentic. As to the business purpose of the transaction, the Court considered the following:

- There was a “genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities” (the form of the transaction was required by government regulations);
- The transaction was “imbued with tax-independent considerations”;
- The transaction “was not shaped solely by tax avoidance features that have meaningless labels attached”; and
- The “Government should honor the allocation of rights and duties effectuated by the parties”.

4.2.2 *Subjective economic substance*

The subjective prong of the economic substance doctrine looks to the taxpayer’s expectations and motives. To satisfy this prong, the taxpayer must demonstrate a non-tax purpose. In this sense, the economic substance doctrine incorporates the business purpose doctrine. In order to satisfy the business purpose requirement, “the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer’s conduct and ... economic situation.”⁷⁸

The question of how significant the nontax purpose must be is left unanswered by the courts.⁷⁹ In many cases, the transaction has no plausible nontax purpose. The taxpayer in *Long Term Capital Holdings* argued that it was primarily motivated to enter the OTC transaction because of the management fees it could earn from OTC and B&B investment. The taxpayer also stressed that accepting investments was its core business. The court was not persuaded.⁸⁰

⁷⁸ *Compaq Computer Corp. v. Comm’r*, 113 T.C. 214 at 224 (1999).

⁷⁹ Bankman, *supra*, at 27.

⁸⁰ *Long Term Capital Holdings*, *supra*, at 186.

As analyzed above, the evidence of claimed reasonableness of the purported primary motivation, fees, is unpersuasive – a prudent investor would not have made the deal. The absence of reasonableness sheds light on Long Term’s subjective motivation, particularly given the high level of sophistication possessed by Long Term’s principals in matters economic. This is demonstrated, for example, by Scholes’ concession that some of Long Term’s principals viewed the added value of OTC and B&B solely to be anticipated tax benefits. Moreover, the construction of an elaborate, time consuming, inefficient and expensive transactions with OTC for the purported purpose of generating fees itself points to Long Term’s true motivation, tax avoidance.

In the *UPS* case (see below), the court stated that “a ‘business purpose’ does not mean a reason for a transaction that is free of tax considerations. Rather, a transaction has a ‘business purpose,’ when we are talking about a going concern like UPS, as long as it figures in a bona fide, profit-seeking business.”⁸¹

4.2.3 Ordinary business exception

The U.S. courts have created an implicit exception for tax-motivated transactions closely tied to ordinary business operations. The economic substance doctrine has been applied mostly to tax shelters and other closed investments where the taxpayer is not already engaged in the particular subject of the investment and stands to profit, if at all, only from the particular investment. Most of the recent corporate tax shelter cases in which the IRS lost fall within this implicit exception. One commentator justifies this exception on pragmatic grounds:

A rule that allows taxpayers to take advantage of loopholes that naturally present themselves in the course of business operations will be expensive to the federal coffers, but that cost will be limited to the number of “naturally present”

⁸¹ *UPS*, at 1019.

loopholes. A rule that allows taxpayers not only to take advantage of loopholes but to manufacture circumstances in which they arise would be ruinous to the fisc.⁸²

In *U.P.S. v. Commissioner* (2001),⁸³ for example, a purely tax motivated transaction was upheld. In this case, the taxpayer was engaged in the exceedingly profitable business of selling parcel insurance. The premiums collected in exchange for providing such insurance are taxable income. In order to minimize its tax on the insurance profit, UPS restructured its insurance program by insuring the risks with an unrelated insurer; as a result, UPS paid the entire premiums over to the insurer and deducted the payment as an expense. The unrelated insurer then reinsured the risk with a Bermuda company that had been formed by UPS and then distributed to the UPS shareholders. As a result, the insurance premiums that UPS had previously reported in its income were being reported by an offshore insurance company that was owned by the UPS shareholders. The Eleventh Circuit of the Federal Court of Appeal held that restructuring should be respected for tax purposes. The court found that there were necessary “economic effects” because UPS was obliged to pay the unrelated insurer and the insurer could proceed against UPS if the insurer defaulted. The insurer also bore the risk of default by the Bermuda company on its obligations under the reinsurance agreement. The restructuring had the necessary business purpose because “when we are talking about a going concern like UPS” the transaction has a business purpose “as long as it figures in a bona fide, profit-seeking business.”

In contrast, economic substance is generally lacking if a taxpayer structured its investment to generate a loss that would serve to offset the tax on completely unrelated income and the transaction that purportedly gave rise to a capital loss that dwarfed the business objectives of the taxpayer and any profits arising from them. These are the so-called “loss generators”.⁸⁴ “An economic substance case that involves a publicly

⁸² Bankman, *supra*, at 18.

⁸³ 254 F. 3d 1014 (11th cir. 2001).

⁸⁴ Bankman, *supra*, at 21.

marketed shelter and a billion dollar price tag is hard to defend as taxpayer's counsel – on that most tax lawyers would agree.”⁸⁵

The difficulty lies in the distinction between these transactions from tax minimization arrangements undertaken as part of the ordinary business. The nature of the economic substance analysis is flexible, thereby giving rise to alternative formulations. Also the US Supreme Court has not spoken in recent years. The circuit courts have adopted different approaches to the interpretation of the objective and subjective prongs of the economic substance doctrine, reaching different conclusions. Given the fact that the case law is in “something of a mess” and that the new fashion in statutory interpretation is for “textualism”,⁸⁶ the Joint Committee on Taxation has recently raised the prospect that the US will introduce a statutory general anti-avoidance rule. The proposal is similar to the previous attempts to codify the "economic substance doctrine" and would be applied to certain transactions that are regarded as tax shelters.⁸⁷

4.3 Codified Economic Substance in Australia and South Africa

The economic substance doctrine is part of the American and, to a much lesser extent, UK common law, although both countries have attempted to enact statutory general anti-avoidance rules that would include this doctrine. In Australia and South Africa, the doctrine has been, or proposed to be, codified, in the statutory GAAR.

4.3.1 Australian GAAR

The Australian GAAR is in Part IVA of the Income Tax Assessment Act. It was intended to provide an “effective general measure against the tax avoidance arrangements that –

⁸⁵ Id., at 22.

⁸⁶ Gregory E. Maggs, “Reconciling Textualism and the Chevron Doctrine: In Defense of Justice Scalia,” (1996) 28 *Conn. L. Rev.* 393; Alexandra M. Walsh, “Formally Legal, Probably Wrong: Corporate Tax Shelters, Practical Reason and the New Textualism” (2001) 53 *Stan. L. Rev.* 1541.

⁸⁷ Marvin A. Chirelstein and Lawrence A. Zelenak, “Tax Shelters and the Search for a Silver Bullet,” (2005) 105 *Colum. L. Rev.* 1939 (describing the ongoing legislative and administrative efforts to curtail tax shelters).

inexact though the words may in legal terms be – are blatant, artificial or contrived”.⁸⁸ The application of Part IVA involves three requirements: (1) there must be a “scheme”; (2) the taxpayer must derive a tax benefit from that scheme; and (3) the scheme must have been entered into for the sole or dominant purpose of obtaining a tax benefit. In determining whether the third requirement is met, an “objective determination” must be made on the basis of a number of factors/tests set forth in s.177D, which include:

- the manner in which the scheme was entered into or carried out. This includes consideration of the way in which, and the method or procedure by which, the particular scheme in question was established.⁸⁹ It may also include considerations such as the degree of unnecessary complexity, the extent of the taxpayer’s involvement, whether the scheme was sold by a promoter, and whether a tax haven is involved.
- Form and substance of the scheme. “Substance” in this context refers to the commercial reality and legal substance of the scheme.⁹⁰ In *Clough Engineering*,⁹¹ the Court considered the fact that many of the transactions had little substance and were more illusory than real, and that the same commercial result could easily have been achieved in a much easier and more direct way.
- Timing. This refers to the time at which the scheme was entered into and the length of the period the scheme was entered into and the length of period during which it was carried out.
- Results that would have been achieved by the scheme if GAAR did not apply.
- Change in financial position of the taxpayer. Inferences adverse to a taxpayer may be drawn if the scheme provides a tax benefit without any significant financial detriment.⁹²

⁸⁸ *Income Tax Laws Amendment Bill (No.2) 1981: Explanatory Memorandum* (Canberra: AGPS 1981, at 2.

⁸⁹ *FC of T v. Spotless Services Ltd & Anor*, (1996) CLR 404.

⁹⁰ Id. One commentator notes, however, that the precise meaning of “form over substance” is still not clear. See G.T. Pagone, “Part IVA: The General Anti-Avoidance Provisions in Australian Taxation” (2003) 27 *Melbourne U. L. Rev.* 770, at 780.

⁹¹ 97 ATC 2023.

⁹² The remaining factors are: the change in financial position of person connected with the relevant taxpayer, any other consequences for the relevant taxpayer or person connected, and the nature of the connection between relevant taxpayer and other person.

The above factors are posited as objective facts. The conclusion whether the dominant purpose of a person is to derive tax benefit must be the conclusion of a reasonable person. In other words, the question is “whether, having regard, as objective facts, to the matters [mentioned above] .., a reasonable person would conclude that the taxpayers entered into or carried out the scheme for the dominant purpose of enabling the taxpayers to obtain a tax benefit in connection with the scheme.”⁹³ The lack of commerciality is a key test in determining the dominant purpose under Part IVA. In *Spotless*,⁹⁴ the Court held that the scheme was not commercial for the simple reason that the interest obtained on the funds was considerably less than the interest that could be derived by deposits in Australia. What made the particular arrangement attractive was the tax consequences. In the absence of the tax benefit, the scheme was unprofitable. Australian courts have not, however, set for clear guidelines for measuring commerciality.⁹⁵

Australian courts seem to be prepared to find commerciality where the form of the transactions serves commercial objectives, such as a sale-leaseback. In *Eastern Nitrogen Ltd. v. FC of T*,⁹⁶ the taxpayer entered into a sale and leaseback arrangement under which it sold its ammonia plant to two financiers and immediately leased it back for a period of five years. It sought to deduct the lease payments. The Court considered the various factors and concluded that the dominant purpose was not to obtain the tax benefit. Carr J. stated:

In my opinion, it is clear that the appellant entered into and carried out the scheme for more than one purpose. One of the purposes was to obtain a tax benefit. ... [B]alancing the various factors above, it cannot be said that the ruling, prevailing or most influential purpose of the appellant was to obtain a tax benefit. I think that a reasonable person would form the view that although that factor was important, the ruling, prevailing or most influential purpose

⁹³ *Spotless*, supra note xx, at 421-2.

⁹⁴ *Id.*

⁹⁵ *Pagone*, supra, at 198.

⁹⁶ (2001) 46 ATR 474. Unlike the transactions in *Canada Trustco*, the arrangement in *Eastern Nitrogen* was not circular and the issue was deductibility of lease payments by the lessee.

was to obtain a very large financial facility on the best terms reasonably available.⁹⁷

4.3.2 Proposed GAAR in South Africa

In South Africa, the SARS proposed a GAAR (new s.103 of the Income Tax Act, 1962).⁹⁸ Under this proposal, whether an arrangement is subject to the GAAR must be determined objectively with reference to the relevant facts and circumstances. These include:

- the form and economic substance of the arrangement, or any step therein or part thereof;
- the time at which the arrangement was entered into and the length of the period during which the arrangement was carried out;
- the result which would, but for the application of GAAR, have been achieved by the arrangement;
- any circular flow of cash or assets between or among parties to that arrangement;
- the lack of any change in the financial position of any person resulting from that arrangement;
- the absence of a reasonable expectation of pre-tax profit in connection with the arrangement after taking into account all costs and expenditure incurred in connection with the arrangement; or
- the value of the tax benefit that would have resulted from the arrangement, but for the application of GGAR, exceeds the amount of pre-tax profit reasonably expected in connection with that arrangement.

The proposed GAAR in South Africa is the most recent legislative initiative in combating aggressive, “impermissible” tax avoidance or tax shelters. The factors listed above incorporate some American judicial principles as well as some statutory provisions under

⁹⁷ Id., para.117 and para. 119.

⁹⁸ For a discussion of the proposed GAAR and policy background, see SARS, *Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962)*, November 2005.

the Australian GAAR. The next part of this paper argues that similar factors should be considered in Canada in order to make GAAR effective.

5. GAAR CALLS FOR “REAL” ECONOMIC SUBSTANCE

5.1 Textual, Contextual and Purposive Interpretation of s.245(4)

Section 245 of the Act does not explicitly codify the economic substance doctrine. However, a textual, contextual and purposive interpretation of this provision can lead to one conclusion: it calls for the consideration of the real economic substance of an avoidance transaction as part of the determination of abusive tax avoidance under s.245(4).

The text of s.245(4) provides that an avoidance transaction is subject to GAAR “only if it may reasonably be considered that the transaction would ... result directly or indirectly in a misuse of the provisions of [the Act or another taxing statute] ... or in an abuse having regard to those provisions, other than this section, read as a whole.” Two notable aspects of this text confirm the relevance of the economic substance doctrine.

- The reasonableness requirement. The reasonableness inquiry in Canadian tax law has always been based on an examination of the facts and circumstances of the case and from the perspective of reasonable third position. For example, in determining whether an amount of expense was reasonable under s.67 of the Act, the court adopted this standard: whether a reasonable businessman having only the business consideration of the appellant in mind would have contracted to pay such an amount.⁹⁹

⁹⁹ *Gabco Ltd v MNR*, [1968] C.T.C. 313 (Exch), *Goldhar Estate v MNR*, [1988] 1 C.T.C. 2187; *Maduke Foods Ltd v The Queen*, [1989] 2 C.T.C. 284 (FCTD) and *Petro-Canada v. R.*, [2004] 3 C.T.C. 156 (FCA).

- The emphasis on the result of the transaction. This “suggests that all the consequences of the transactions –legal, financial, commercial, and economic – should be considered.”¹⁰⁰

The historical context of the enactment of s.245 confirms “that the economic realities must be relevant under subsection 245(4) if the GAAR is to be effective in preventing abusive tax avoidance.”¹⁰¹ GAAR was introduced in reaction to the Supreme Court of Canada decision in *Stuart Investments Ltd. v. R.* (1984).¹⁰² In this case, the Court had rejected the business purpose doctrine and the economic substance doctrine that are used in the United Kingdom and the United States in controlling tax avoidance. The Court had also refused to interpret the provisions of the Act in light of their object and purpose, a statutory interpretation approach that would help minimize tax avoidance. GAAR was intended to be a provision of the last resort and would apply only to transactions that have otherwise complied with all of the other relevant provisions of the Act. Since the economic substance doctrine is generally irrelevant in applying the provisions of the Act other than s.245, the transactions giving rise to the tax benefit must be characterized in accordance with the legal form. “Accordingly, it is difficult to see how transactions could be considered to be abusive if the economic substance of what the taxpayer did cannot be considered.”¹⁰³

The legislative intention of s.245 is to combat abusive transactions while not interfering with legitimate tax planning. The Explanatory Notes to Bill C-139 describe the purpose of s.245 as follows:

The wording of the new provision [s.245] is intended to encompass all types of abusive and artificial tax avoidance schemes...

Subsection 245(4) recognizes that the provisions of the Act are intended to apply to transactions with real economic substance, not to transactions

¹⁰⁰ Brian Arnold, “The Long, Slow, Steady Demise of the General anti-Avoidance Rule” (2004) 52 *Can. Tax J.* 488 at 507.

¹⁰¹ Arnold (2004), at 507.

¹⁰² [1984] C.T.C. 294, 84 D.T.C 6305 (S.C.C.), para.72.

¹⁰³ Arnold (2004), *supra*, at 507.

intended to exploit, misuse or frustrate the Act to avoid tax.¹⁰⁴

Clearly, unless an avoidance transaction lacking real economic substance is either contemplated or encouraged by the provisions of the Act, the transaction falls outside the legislative intent. In the meantime, it is clear that Parliament recognized “that tax planning – arranging one’s affairs so as to attract the least amount of tax – is a legitimate and accepted part of Canadian tax law.”¹⁰⁵ The economic substance doctrine is helpful in distinguishing between contrived, artificial tax avoidance and legitimate tax minimization arrangements.

In conclusion, the economic substance doctrine should play a crucial role in the abusive tax avoidance analysis as it is called for by the wording, context and purpose of s.245. More importantly, “economic substance” should mean “real economic substance” and it can be determined on the basis of objective factors.

5.2 Determination of Real Economic Substance

Drawing from the foreign jurisprudence discussed earlier in this paper, in determining the real economic substance of a transaction, a “reasonable person” standard should be adopted. Such test is consistent with Canadian jurisprudence.

There are various factors for the determination of economic substance. One factor is the amount of potential pre-tax profit. The crucial question is how much profit is enough. Obviously, a dollar’s worth of economic profit is insufficient.¹⁰⁶ Should pre-tax profit be measured by pretax rate of return, and if so, what rate of return is high enough to give a transaction substance? Unfortunately, there is no clear answer to this question, even in the United States where the jurisprudence on the economic substance doctrine is most

¹⁰⁴ Canada, Department of Finance. *Explanatory Notes to Legislation Relating to Income Tax*. Ottawa: Queen’s Printer, 1988, at 464-5. The Supreme Court of Canada quoted the above paragraph in *Canada Trustco* (paras. 48-49).

¹⁰⁵ *Explanatory Notes*, supra, at 464.

¹⁰⁶ Alvin C. Warren, Jr., “The Requirement of Economic Profit in Tax Motivated Transactions,” (1981) 59 *Taxes*, 985at 989.

developed. It is not because the courts have come out differently on the question, but rather no tax shelter case has yet involved any positive return, once transaction costs are taken into consideration.¹⁰⁷

In *Long Term Capital Holdings*, the Court used the rate of return that was achieved by the taxpayer in its hedge funds. The US proposed rules to codify the economic substance doctrine¹⁰⁸ suggested the use of at least a risk-free rate of return. The rationale for this test is that the taxpayer has placed some of its money at risk. In many of the tax shelter cases in the United States, the taxpayer had not only negative returns after transaction costs, but also hedged away the possibility of any upside or downside risk.

Another way of determining economic substance is to compare the amount of tax savings and the amount of pre-tax profit. A transaction lacks economic substance unless “the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respect.”¹⁰⁹

Third, a transaction has economic substance if it changes in a meaningful way (apart from tax effects) the taxpayer’s economic position. In other words, a transaction lacks substance if did not expose the taxpayer to any economic risk, or offer the taxpayer any opportunity for profit, that was meaningful in relation to the tax benefits it gave rise to. All in all, it was simply a “game” described by Lord Templeman:¹¹⁰

The game is recognized by four rules. First, the play is devised and scripted prior to the performance. Secondly, real money and real documents are circulated and exchanged. Thirdly, the money is returned by the end of the performance. Fourthly the financial position of the actors is the same at the end as it was in the beginning save that the taxpayer in

¹⁰⁷ Bankman, *supra*, at 23.

¹⁰⁸ Proposed 7701(n)(1)(B) of the Jumpstart Our Business Strength (JOBS) Act, S.1637, 108th Cong. (1st Sess. Nov. 7, 2003).

¹⁰⁹ Proposed 7701(n)(1)(B), *supra* note .

¹¹⁰ *Ramsay (W.T.) Ltd. V. I.R.C.* [1979] 3 All E.R. 213 (C.A.) at 214-5.

the course of the performance pays the hired actors for their services. The object of the performance is to create the illusion that something has happened, that Hamlet has been killed and that Bottom did don an asses [sic] head so that tax advantage can be claimed as if something had happened.

Because the objective prong of the American economic substance test is already codified under s.245(3), it is not necessary to revisit the question whether obtaining tax benefit was the primary purpose of the taxpayer. Similarly, the “series of transactions” conception under s.245(2) already permits the examination of the various steps of an arrangement to be considered together, there is no need to revisit this analysis in determining economic substance under s.245(4).

5.3 Economic Substance and Legislative Purpose

In stating that the economic substance doctrine may be relevant at various stages of GAAR analysis, the Court was presumably referring to the different stages of analysis under s.245(4) only. Both the Explanatory Notes and the SCC recognize in *Canada Trustco* and *Kaulius* that recharacterization of the taxpayer’s transaction is prohibited at the stage of determining whether or not the transaction is an avoidance transaction under s.245(3).

According to the SCC, in determining whether an avoidance transaction is abusive in nature under s.245(4), the court must determine the legislative purpose of the provision after a textual, contextual and purposive interpretation of the provision, and then determine whether it may reasonably be considered that the avoidance transaction frustrates this legislative purpose. This is a mixed question of law and fact. As a matter of statutory interpretation, the economic substance doctrine can help establish the meaning and purpose of the statutory provisions. Where statutory provisions are intended to apply to transactions with real economic consequences, obviously they cannot be applied to a transaction that has no or insufficient economic substance. Examples are

Kaulius, and *Gregory v. Helvering*. As a matter of factual determination, the economic substance doctrine has a more natural fit. It helps the court to determine whether there are enough objective facts to demonstrate that a transaction is what the taxpayer describes in a real commercial, business world. In other words, is it a sheep or a wolf in sheep's clothes? Obviously, if a provision was intended to apply to sheep only, a wolf in sheep's clothes should be disqualified.

With respect to the relationship between economic substance and legislative purpose, the SCC's interpretation of s.245(4) is too restrictive. The Court stated in *Canada Trustco* that the economic substance of transactions is relevant only where the object, spirit and purpose of the relevant provisions of the Act limit tax benefits to transactions with real economic substance (para.76). It also stated that "a transaction may be considered to be 'artificial' or to 'lack substance' with respect to specific provisions of the Income Tax Act" (para.60). The SCC's position is too narrow for the following reasons. First, as argued earlier, the broad language in s.245(4) (i.e., a transaction would result directly or indirectly in an abuse having regard to those provisions ... read as a whole") and the legislative context and intention require a broader application of the real economic substance doctrine. GAAR was enacted to deal with transactions that generally take advantage of the literal application and interaction of several different, often seemingly unrelated, highly specific provisions of the Act. If abusive tax avoidance analysis were limited to the "relevant provisions" of the Act, albeit in a contextual manner, it would defeat the legislative purpose of the GAAR. Second, the SCC seemed to accept the position stated in the Explanatory Notes that the provisions of the Act are intended to apply to transactions with real economic substance. In a sense, this statement creates a presumption that transactions lacking real economic substance are not intended to benefit from the statutory provisions of the Act. As such, there is no need for this general presumption to be explicitly expressed in every provision of the Act.

Consequently, the economic substance doctrine should be relevant in all cases involving s.245(4). Based on the GAAR cases thus far, it is difficult to find transactions that have real economic substance. Of course, the SCC is correct in saying that the analysis under

s.245(4) does not depend entirely on “substance” viewed in isolation of the legislative purpose. Once a transaction is characterized as lacking real economic substance, the controlling question is whether it frustrates the legislative purpose. That does not mean that the court is precluded from considering economic substance in the first place. Furthermore, there seems to be a presumption that a transaction without real economic substance frustrates the legislative purpose unless it can be reasonably concluded that such transaction is intended to fall outside the GAAR.

As the cases discussed in this paper indicate, litigation involving the economic substance doctrine frequently involves disputes over the text, intent, or purpose of the relevant statute. Generally, the taxpayer will defend its position by arguing that the disputed transaction is supported by the statute’s text, and in some cases, the intent and purpose. The ultimate and most challenging question is, therefore, “were the benefits arising from the avoidance transaction intended by Parliament?”

At a general level, the relationship between the economic substance doctrine and legislative purpose is clear: “a transaction that is clearly supported by the text, intent, and purpose will withstand judicial scrutiny regardless of whether it otherwise meets the economic substance test.”¹¹¹ In other words, if the result is clearly intended by Parliament, the taxpayer should enjoy the tax benefit even when the transaction does not have any economic substance. Similarly, if the provisions of the Act were clearly intended not to apply to a transaction without real economic substance, saving the transaction from the GAAR will defeat the legislation intent. “But people rarely go to court with clear cases. Why waste time and money?”¹¹²

When the taxpayer or the Minister goes to court, especially to the SCC, the case often

¹¹¹ J. Bankman, “The Economic Substance Doctrine,” (2000) 74 *Cal. L. Rev.* 5, at 11.

¹¹² “All judges follow a simple rule: when the statute is clear, apply it. But people rarely come to court with clear cases. Why waste time and money?” paraphrased. See Easterbrook [US Court of Appeals, 7th Circuit], “Text, History, and Structure in Statutory Interpretation,” (1994) 17 *Harv. J. L. & Pub. Pol’y*, 61, at 61.

involves interpretative issues that are not very clear. Ambiguity may arise from the different approach to statutory interpretation. A liberal, purposive interpretation may reveal a broader purpose that requires the transaction to have real economic substance, while a literal interpretation of the specific provisions may not have such requirement. Arguably, *Kaulius* falls into this scenario. Ambiguity may also arise where the provisions of the Act read as a whole may not reveal any coherent policy or purpose, but instead a number of anomalous and inconsistent ad hoc measures adopted in response to particular cases, budget initiatives, immediate revenue needs, or lobbying by special interest groups. In such cases, the SCC made it clear that a finding of abuse is only warranted where it cannot be reasonably concluded that the avoidance transaction was consistent with the object, spirit or purpose of the provisions of the Act. “In other words, the abusive nature of the transaction must be clear.” (*Canada Trustco*, para.62).

In some cases, the Act may provide different treatments of the same or similar economic transactions depending only on legal form and Parliament let taxpayers elect between the two treatments. For example, because the Act treats the cost of financing (i.e., dividends and interest) differently, the taxpayer might take advantage of the interest deduction through debt financing rather than equity financing. Similarly, the decision to retain corporate profit to enhance the value of its shares rather than to distribute the profits to shareholders by way of dividends leads to different tax treatment because capital gains are taxed differently from dividends. Generally speaking, the economic substance doctrine will not be applied to deprive the taxpayer’s choice in using a more tax-effective structure. In other words, where two alternative forms of the same economic transaction are permitted by the Act, the economic substance doctrine should not be used to recharacterize the transaction.

5.4 Economic Substance and Type of Statutory Provisions

The relevance of the economic substance doctrine in determining whether a transaction frustrates the legislative purpose of a provision may depend on whether a statutory term is a term of art (terms that draw their meaning from the statute itself) or a term of “life”

(terms that draw their meaning from life). In the case of applying statutory terms of art, the economic substance doctrine is largely irrelevant. ‘Substance’ can only be derived from forms created by the statute itself. Here substance *is* form and little else; there is no natural law of reverse triangular mergers.”¹¹³ In the case of applying statutory terms that draw their meaning from life (commercial, business or financial), the ultimate question is what it is that taxpayers have actually done. Because Parliament often cannot define a transaction or a concept with enough specificity, Parliament may simply use a common commercial term instead of specifically enumerating the requirements that a taxpayer must perform in order to receive a tax deduction or other benefits. When a taxpayer claims a benefit under this type of statutory provisions, the courts should define the term by using “life in all its fullness”¹¹⁴ because “that is where the term originated.”¹¹⁵ Lord Hoffman wrote: ¹¹⁶

If the statute required something which had a real commercial existence, like a profit or loss, then a series of preordained transactions which taken together produced no profit or loss would not satisfy the statute. On the other hand, if all that the statute required was something which had a particular legal effect, like discharging a debt or passing title to property, then a transaction which had that effect satisfied the statute even it had no business purpose.

The distinction between terms of art and terms of life is “not an unreasonable generalization,” but it should not “provide a substitute for a close analysis of what the statute means.”¹¹⁷ Indeed, that “would be the very negation of purposive construction.”¹¹⁸ The extent to which the economic substance doctrine is relevant in a GAAR analysis depends on the court’s interpretation of the legislative purpose. The narrower view of the legislative purposes often means less relevance of the economic substance doctrine.

¹¹³ Isenbergh, *supra*, at 879.

¹¹⁴ *Welch v. Helvering*, 290 US 111, at 115 (1933).

¹¹⁵ Patton, *supra*, at 515.

¹¹⁶ Hoffman, *supra*, at 203. This is also included in his speech in *MacNiven*, *supra* note xx.

¹¹⁷ *Barclays Mercantile*, *supra*, para.38.

¹¹⁸ *Id.*

For example, a broader interpretation of the purpose of the CCA provisions of the Act is “to provide for the recognition of money spent to acquire qualifying assets to the extent that they are consumed in the income-earning purpose,”¹¹⁹ or even broader – “to recognize the true economic cost consumed in the income-producing process” in order to obtain the “accurate picture” of profit. The broader interpretation is more consistent with the general design of the Act – “provisions of the Act are intended to “apply to transactions with real economic substance”. More specifically, the deduction for CCA is relevant to the calculation of profit under s.9. As the SCC has stated in *Canderel v. R.* (1998)¹²⁰ that the goal of profit computation is “to obtain an accurate picture of the taxpayer's profit for the given year.”¹²¹ Whether the picture of a taxpayer's profit is accurate or not is measured against the commercial reality (e.g., financial accounting). In this sense, interpreting cost of depreciable property to be the amount on paper as opposed to the amount in real commercial sense would distort the picture of profit. “Profit”, “loss” and “cost” are perhaps typical terms used in the Act that draw their meaning from commercial life. Such broader interpretation of purpose will, thus, require the term “cost” be given a meaning that is based on the economic substance of the transactions.

A narrower interpretation of the purpose of the CCAP provisions was the one adopted by the Supreme Court in *Canada Trustco* – to permit deduction of CCA based on the “cost of the assets acquired” (para.74). This interpretation of the legislative purpose makes it unnecessary to inquire whether the cost has any real economic consequences. Legal substance of the transaction (or the price shown in the documentation) is good enough.

5.5 Economic Substance and Taxpayer's Right to Tax Planning

¹¹⁹ *Water's Edge*, supra, para.44.

¹²⁰ Note 2, above.

¹²¹ *Canderel*, para. 53.

The economic substance doctrine does not deny the taxpayer's right to tax planning. Learned Hand J., who was credited for creating the economic substance doctrine, anticipated this:¹²²

[A] transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.

The so-called choice principle is also clearly recognized by the courts in Australia and UK and the US. When a taxpayer has a choice in structuring business transactions, the choice of the more tax-effective structure is not taken away by the economic substance doctrine. However, the economic substance doctrine operates in tension with the two other principles set forth in the *Duke of Westminster*, namely, the strict, literal approach to interpreting statutory provisions, and the characterization of facts in accordance with the form of the transactions.

6. CONCLUSIONS

This paper has discussed the various notions of “economic substance” and concluded that the SCC did not clarify whether this expression means “real economic substance” or just “legal substance”. The Court's position on the notion of “abusive tax avoidance” under s.245(4) and the relevance of the economic substance doctrine is too restrictive. Although the Court did not reject the economic substance doctrine in a GAAR context, it did not provide much guidance to future courts. Further clarification is certainly required in order to give GAAR the effect intended by Parliament. The application of the economic substance doctrine as a matter of common-law or statutory law in other countries should

¹²² *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

provide some guidance for Canadian law-makers and courts in introducing this doctrine into Canadian tax law.

Since s.245 already codified the “step transaction” doctrine through the “series of transaction” concept and the “business purpose” doctrine through the requirement of “bona fide purpose” test under s.245(3). It is perhaps time to consider codifying the real economic substance doctrine. Otherwise, the courts should take an active role in giving full meaning to the GAAR by considering the real economic substance in determining abusive tax avoidance. After all, “the provisions of the Act are intended to apply to transactions with real economic substance”.